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IN THE

Supreme Court of the United States

OCTOBER TERM, 1943

No. 644

VALENTINE-CLARK CORPORATION,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT, AND BRIEF IN SUPPORT THEREOF

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PETITION

Valentine-Clark Corporation prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Eighth Circuit in this cause, wherein an order by that court was filed August 31, 1943, denying a petition by the petitioner for a rehearing. By order of this Court dated November 4, 1943, the time for filing this petition was extended to and including January 29, 1944.

QUESTIONS PRESENTED

1. Whether the phrase "amounts which can be distributed" in Section 26 (c) (1) of the Revenue Act of 1936 includes not only the taxpayer's assets but also the taxpayer's own shares of capital stock and evidences of indebtedness.

2. If the latter construction be correct, whether credit under said provision is to be denied where all shares of capital stock authorized by the taxpayer's charter are outstanding and where the taxpayer is a party to a contract prohibiting "withdrawals from the corporate funds."

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1936, c. 690, 49 Stat. 1648:

Sec. 14. *Surtax on Undistributed Profits.*

(a) *Definitions.*—As used in this title—

(1) The term "adjusted net income" means the net income minus the sum of—

(A) The normal tax imposed by section 13.

(B) The credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

* * * * * *

(2) [as amended by Section 501 (a) (1) of the Revenue Act of 1942, c. 619, 56 Stat. 798] The term "undistributed net income" means the adjusted net income minus the sum of (A) the dividend paid credit provided in section 27, (B) the credit provided in section 26 (c) relating to restrictions on payment of dividends, (C) except in cases where section 26 (c) (1) is applicable, the deficit credit provided in section 26 (f), and (D) the redemption credit provided in section 26 (g).

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum

of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

* * * * * * *

Sec. 26. *Credits of Corporations.*

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * * * *

(c) *Contracts Restricting Payment of Dividends.*—

(1) *Prohibition on Payment of Dividends.*—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) *Disposition of Profits of Taxable Year.*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

(3) *Double Credit not Allowed.*—If both paragraph (1) and paragraph (2) apply, the one of such paragraphs which allows the greater credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

Sec. 115.

* * *

(f) *Stock Dividends.*—

(1) *General Rule.*—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.

Regulations 94, promulgated under the Revenue Act of 1936:

Art. 26-2.

(b) Prohibition on payment of dividends.—The credit provided in section 26 (c) (1) is allowable only with respect to a written contract executed by the corporation prior to May 1, 1936, which expressly deals with the payment of dividends and operates as a legal restriction upon the corporation as to the amounts which it can distribute within the taxable year as dividends. If an amount can be distributed within the taxable year as a dividend—

(1) in one form (as, for example, in stock or bonds of the corporation) without violating the provisions of a contract, but can be distributed within the taxable year as a dividend in another form (as, for example, in cash) without violating such provisions, or

(2) at one time (as, for example, during the last half of the taxable year) without violating the provisions of a contract, but can not be distributed as a dividend at another time within the taxable year (as, for example, during the first half of the taxable year) without violating such provision—

then the amount is one which, under section 26 (c) (1), can be distributed within the taxable year as a dividend without violating such provisions.

STATEMENT

The petitioner, a Washington corporation, is engaged in the business of treating cedar poles and other forest products. It keeps its books and files its income-tax returns on the accrual basis of accounting. (R. 16, 28, 30.) During 1935 up to December 30, 1935, its total authorized and outstanding capital stock consisted solely of 1,000 shares of common stock of the par value of $100 each, all beneficially owned by Lillian S. Clark and her daughter Grace C. Pyle. (R. 16-17, 28-29.) M. H. Sperry acted as general manager under a contract providing for an annual salary of $7,500 plus 50% of the net earnings. (R. 16, 30-31.)

In July, 1935, the petitioner was without adequate working capital. The bank with which it did business not only refused to increase its loans, but insisted on payment of indebtedness already existing, at the same time advising that it would make further loans only on two conditions: (1) that annual withdrawals for salaries of officers and for dividends be limited to $12,000; and (2) that Mr. Sperry as active manager have a personal investment at stake in the enterprise. (R. 17, 32-34, 42-43, 45, 47-48, 57.) Conferences resulted on November 18, 1935, in the signing by the petitioner, the shareholder, and Mr. Sperry of a Memorandum of Agreement. The memorandum recited first that the bank had promised to extend a $25,000 line of credit to the petitioner "upon certain conditions". It was then provided therein, among other things, that Mrs. Clark "agrees that, so long as such line of credit is made available" to the petitioner "and/or so long as any indebtedness" is owing thereunder, "she will not make or permit withdrawals from the corporate funds to herself or any members of her family by way of salaries, dividends, loans or advances in excess of $6,000 per year", and that Mr. Sperry "agrees that

so long as" the same conditions prevail "he will not draw out in cash more than $6,000 per year" under his contract of employment. The memorandum provided further that it was to become effective January 1, 1936, and that the petitioner "assents to and approves the foregoing agreements and provisions". A copy of the memorandum was delivered to the bank. (R. 17-20, 35-36, 43-44, 45-46, 58-64.)

Five days later, in order to conform with the bank's further requirement that Mr. Sperry acquire a personal investment in the enterprise, Mr. Sperry, Mrs. Clark, and Mrs. Pyle signed another Memorandum of Agreement, of which likewise a copy was supplied to the bank. This memorandum provided, among other things that Mrs. Clark and Mrs. Pyle on or before January 1, 1936, would cause the petitioner's capital structure to be revised so as to authorize the issuance of 1,500 shares of 4% preferred stock of a par value of $100 each and to reduce the number of authorized common shares to 200 without par value; that while all the preferred shares would be issued to Mrs. Clark and Mrs. Pyle, the common shares should be issued one-half to them and one-half to Mr. Sperry; that the latter's contract of employment would be terminated and he be given a new contract providing for a minimum annual salary of $6,000; and that the agreement of November 18, 1935, should be modified to the extent necessary to give effect to the provisions governing Mr. Sperry's future employment. On December 30, 1935, the terms of this second memorandum were carried out, and thereafter, until July 1, 1937, all 1,500 preferred shares were owned by Mrs. Clark and Mrs. Pyle and the common shares were owned one-half by them and one-half by Mr. Sperry. (R. 20-21, 29, 30, 36-37, 41, 44, 45-46, 64-72, 77-82.)

In reliance on the two agreements the bank opened a line of credit to the petitioner. The line was continuously available and the petitioner was continuously indebted there-

under from January 1, 1936, to June 30, 1937, inclusive. At no time during this period could the petitioner have paid its debt to the bank in full without adversely affecting its business and competitive position. (R. 21, 37-38, 41-42, 46, 49.)

In November, 1936, the petitioner orally asked permission of the bank to pay dividends and salaries in excess of the limits set by the contract of November 18, 1935. Such permission was denied as to dividends, but the bank gave approval to payment of a $2,500 bonus to Mr. Sperry and this bonus was paid. (R. 21, 38, 44, 46.) In June, 1937, the petitioner again requested the bank, at first orally and then by letter, for permission to pay dividends in excess of such limits. The bank, first orally and then by letter, gave permission to pay a dividend on its common stock of $5,000 in cash and $15,000 in the petitioner's notes on condition that the notes be subordinated to all bank loans and run for at least two years. A dividend was declared and paid as thus permitted. (R. 22, 38-39, 47, 73-76.) While no finding on the subject was made by the Tax Court (then the Board of Tax Appeals), the trial tribunal, Mr. Sperry and the bank officer in charge of the petitioner's account, the only witnesses, both testified that they understood and interpreted the contract of November 18, 1935, as prohibiting the payment not only of dividends in cash or other of the petitioner's assets, but also of dividends in the petitioner's notes. (R. 39-40, 46, 47, 48.)

In its returns for the taxable year 1936 and the taxable period ended June 30, 1937, the petitioner, for purposes of the surtax imposed by Section 14 (b) of the Revenue Act of 1936 on "undistributed net income" as defined in Section 14 (a) (2) of the Act, claimed a credit under the provisions of Section 26 (c) (1) of the Act. The credit was disallowed by the Commissioner. (R. 10-13, 28.) On review the Tax

Court sustained the Commissioner's action on the ground (R. 24) that the contract of November 18, 1935, did not prohibit "the payment of dividends in stock, taxable or otherwise". Its opinion did not refer to the fact that all authorized capital stock was outstanding.

The Circuit Court of Appeals affirmed the Tax Court on the ground that the contract "did not prohibit the payment of dividends by petitioner in any form except in cash"; that by Section 26 (c) (1) "the intention of Congress was to grant the credit claimed only when the distribution of dividends in any form taxable in the hands of the shareholders was prohibited"; that dividends in the petitioner's own shares of capital stock and in its own "bonds or long-term obligations" could have been paid; and that it was immaterial that all authorized capital stock was outstanding.

SPECIFICATION OF ERRORS TO BE URGED

1. The Circuit Court of Appeals erred in holding that the phrase "amounts which can be distributed" in Section 26 (c) (1) of the Revenue Act of 1936 includes amounts which, like shares of the taxpayer's own capital stock, can be distributed without depleting the taxpayer's assets.

2. The Circuit Court of Appeals erred in holding that the contractual prohibition upon "withdrawals from the corporate funds" did not include dividend-distributions of the taxpayer's own obligations.

3. The Circuit Court of Appeals erred in holding that it was immaterial that all the petitioner's authorized capital was outstanding.

4. The Circuit Court of Appeals erred in affirming the decision of the Tax Court.

REASONS FOR GRANTING THE WRIT

1. The principal issue relates to the construction to be placed on Section 26 (c) (1) of the Revenue Act of 1936, particularly the phrase "amounts which can be distributed". Viewed broadly, the question is whether the phrase refers only to asset-distributions or whether it includes also distributions of shares of the taxpayer's own capital stock. However, the latter interpretation, once adopted, raises further questions of interpretation, among them (a) whether the taxpayer's own shares "can" be distributed where all authorized shares are outstanding and (b) whether "amounts" includes non-taxable share-distributions as well as taxable ones. These questions have never been before this Court, and the course of the decisions in the lower courts indicates that their solution is not easy. There is need under the circumstances for a definitive interpretation by this Court.

2. The issue has been dealt with, from one angle or other and under varying facts, in more than a score of cases in the lower courts, and several cases are now pending, some of which are referred to below.

3. While it cannot be said definitely that there is at present a conflict of decisions, the decided cases indicate quite clearly considerable diffidence and uncertainty on the part of the courts, if indeed they have not been guilty of floundering.

The first statement on the subject appears to be a brief declaration made *obiter* in *Columbia River Paper Mills* v. *Commissioner*, 43 B. T. A. 263, decided January 7, 1941, stating, without more (p. 266), that the Tax Court agrees with the Commissioner that credit is not allowable if distribution of the taxpayer's own shares is not prohibited. However, the effect of this statement was limited by *Paraport*

Theatre Leasing Corporation v. *Commissioner*, 44 B. T. A. 108, decided April 8, 1941, wherein it was held (pp. 111-2) that credit is allowable even though share-distributions are not prohibited if such distributions as are authorized by the taxpayer's charter would not be taxable to the shareholders.

United States v. *Dakota Tractor & Equipment Co.*, 125 F. (2d) 20, certiorari denied, 316 U. S. 671, decided by the Circuit Court of Appeals for the Eighth Circuit on January 7, 1942, took the opposite view, though no reference was made to the *Paraport* decision. The opinion assumed (p. 26) that only share-distributions were permissible, and decided (pp. 26-67) that no credit was allowable though the taxpayer had but one authorized class of stock, which, however, was not fully issued. Shortly thereafter, on February 11, 1942, the Tax Court held in *Helms Bakeries* v. *Commissioner*, 46 B. T. A. 308, that credit was not allowable where share-distributions were not prohibited and the taxpayer had more than one class of stock authorized, none of them fully issued, the *Paraport* decision being distinguished because of this fact (p. 318).

On March 31, 1942, the Tax Court decided the present cause. *Valentine-Clark Corporation* v. *Commissioner*, 46 B. T. A. 821. It disallowed the credit on the ground (p. 828) that share-distributions were not prohibited, citing the *Helms* decision as authority. It seems fair to say that this conclusion was the result of inadvertent oversight of the fact that the taxpayer had no unissued authorized stock; while the *Paraport* case was cited for comparison, there is nothing to indicate that the Tax Court intended to overrule the holding in that case to the effect that credit will not be denied if the taxpayer is without unissued authorized stock. That the Tax Court's decision in this cause was inadvertent is quite clear from the circumstance that in another decision handed down the very same day, *Oswego Falls Corporation*

v. *Commissioner*, 46 B. T. A. 801, the Tax Court allowed the credit though share-distributions were not ~~permitted~~ prohibited inasmuch as the taxpayer was not in a position to issue shares which would have been taxable to the shareholders, the opinion stating (p. 808) that "We have consistently held that the ability or authority to pay a dividend does not preclude the allowance of the credit", citing the *Paraport* case, and stating further (p. 808) that the Tax Court could not agree with the contrary view advanced in the *Dakota* case, which had likewise been cited for comparison in the Tax Court's decision in this cause.[1]

Thereafter the Tax Court continued to adhere to the position adopted in the *Paraport* and *Oswego* cases. In *Northwest Bancorporation* v. *Commissioner*, an unreported "memorandum" decision decided March 6, 1943 (see 433 Commerce Clearing House, p. 8530, Par. 7245 (M)), it was held that the credit was allowable though share-distributions were permissible, since the taxpayer had only one authorized class of stock. The *Paraport* and *Oswego* cases were followed, the Tax Court stating again that it considered the *Dakota* decision in error. The *Northwest Bancorporation* case is now pending on appeal before the Circuit Court of Appeals for the Eighth Circuit.[2]

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[1]Notwithstanding they were both decided the same day, the Tax Court's decision in this cause and its decision in the **Oswego** case are clearly in conflict. This is probably due to the circumstance that both were "unreviewed" or one-man decisions. See Section 1118 (b) of the Internal Revenue Code. The **Oswego** decision was reversed upon appeal on the ground that the contract did not prohibit dividends in the taxpayers' own long-term obligations. 137 F. (2d) 173 (C. C. A. 2d).

[2]The taxpayer in the present cause is represented by the same counsel as the taxpayer in the **Northwest Bancorporation case.** The latter was argued before the Eighth Circuit on November 9, 1943, and it was because of the pendency of that case that application was made in this cause for extension of the time for filing a petition for certiorari. It is the taxpayer's intention in the **Northwest Bancorporation** case to ask for certiorari in the event of an adverse decision, which appears likely in view of the decision of the same court in the **Dakota** case. It was felt that both cases should be brought before this Court at one time since they present the same general issue under somewhat varying facts. Unfortunately decision in the **Northwest Bancorporation** case has been delayed longer than was anticipated.

In this state of the decisions[3] the present cause came before the same Circuit Court and was decided August 3, 1943. As already pointed out, the court interpreted the contract as permitting both obligation and share-distributions, and because of this denied the credit. In this connection it reaffirmed the correctness of its decision in the Dakota case. However, in doing so it interpreted that decision (pp. 483-484) as involving a contract permitting obligation-distributions as well as share-distributions, though the *Dakota* opinion itself assumes that only the latter were permitted and though the Tax Court decisions indicate that the Tax Court has always read the opinion as so assuming. Furthermore, it stated (p. 484) that "We are not concerned here * * * with the reasons advanced in support of" the *Dakota* decision.

Notwithstanding this doubt cast upon the soundness of that decision, when read as written, by the very court by which it was pronounced, the Tax Court a month later, on September 9, 1943, departed from the doctrine to which, except in this cause, it had theretofore consistently adhered, evidenced by the *Paraport*, *Oswego*, and *Northwest Bancorporation* decisions, and accepted the ruling of the *Dakota* decision as correct, at the same time citing the decision of which review is here sought. It did this in *Kaufmann Department Stores Securities Corp.* v. *Commissioner*, 2 T. C. 656, 669, in which only share-distributions were permitted and the taxpayer had only one class of authorized stock—precisely the same facts legally as in the *Northwest Ban-*

In the event of an adverse decision in that case, the taxpayer will promptly file an application for certiorari. It appears not improbable that the Commissioner will do likewise in the event of a decision unfavorable to him, since the consequent overruling of the **Dakota** decision makes doubt appear, and since the Tax Court has recently embraced the rule of that decision.

[3]It should be pointed out that credit was denied in **Commissioner** v. **Columbia River Paper Mills** (C. C. A. 9th), 127 F. (2d) 558, on the ground that share-distributions were not prohibited (p. 561). However, there were two classes of authorized stock, only one of which was fully issued.

corporation case and as in the *Dakota* case when read on the basis of the facts assumed in the opinion.

The result of the vagaries and shifting in the cases dealing with the issue is an increasing confusion—a condition that will be even worse if the court below should decide the *Northwest Bancorporation* case favorably to the taxpayer. Such confusion should not be permitted to continue, particularly where it relates to the meaning of a Federal taxing statute.

4. There are persuasive reasons for believing the decision below is in error. The principal ones are set out in the brief in support submitted herewith.

Wherefore it is respectfully submitted that the petition should be granted.

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January, 1944

BRIEF IN SUPPORT OF PETITION

OPINIONS BELOW

The opinion of the Tax Court (R. 15-25) is reported in 46 B. T. A. 821. The opinion of the Circuit Court of Appeals for the Eighth Circuit is reported in 137 F. (2d) 481.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered August 31, 1943. An order was filed by this Court on November 4, 1943, extending the time for filing a petition for a writ of certiorari until and including January 29, 1944. Jurisdiction is conferred upon this Court by Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED, STATUTES INVOLVED, ETC.

A statement of the questions presented, specification of errors, a statement of the case, and the statutes and regulations involved are set out in the petition.

ARGUMENT

The Statutory Phrase "Amounts Which Can Be Distributed" Does Not Include the Taxpayer's Own Capital Stock.

First. The purpose of a contract prohibiting payment of dividends is to provide security for creditors or others holding obligations prior to the claims of shareholders. The creditor of a corporation is not normally concerned with whether his debtor distributes shares of its capital stock,

for any claims thereby accruing are subordinate to his own, and hence share-distributions are usually not prohibited in such contracts.

For this reason an interpretation of the statutory phrase as including share-distributions leaves little if anything upon which the statute can operate, and violates the oft-reiterated rule that, where another interpretation is reasonably permissible, a statute should not so be construed as to deprive it of all practical utility and leave it a nullity.

Second. In the *Dakota* case (p. 26) it was assumed that the court was called upon to construe the word "dividends". This is error; the critical word is "amounts", and this refers to earnings and profits.

"Amounts of earnings and profits" is the phraseology used in subdivision (2) of Section 26 (c), which is *in pari materia* with subdivision (1), the provision here in issue, since, as their common title "Contracts Restricting Payment of Dividends" indicates, the two "deal with precisely the same subject matter" (*United States* v. *Stewart*, 311 U. S. 60, 64), namely, the allowance of credit by reason of restrictive contracts. "Earnings and profits" in subdivision (2) can be represented only by the corporate debtor's property; it is only that, not the power to declare stock dividends, which can discharge indebtedness. Similarly, "amounts" in subdivision (1) can be represented only by the corporate debtor's property; for earnings are retained for the security of creditors, not by failure to declare stock dividends, but only when the corporation's property is not distributed.

Third. Legislative history supports the construction urged by the petitioner. As originally proposed, Section 26 (c) (1) provided for a credit only if there was "no form in which dividends" could be paid. H. R. 12395, Section 15 (a), 74th Cong., 2nd Sess. It was changed to its present lan-

guage on the floor of the Senate. 80 Cong. Rec. 9071. In explaining the change, Senator LaFollette, one of the Conference Managers on the part of the Senate, said that the new provision was "a much broader and more liberal one" than that originally proposed. 80 Cong. Rec. 10470. The only possible liberalization of any substantial consequence was to remove the condition that credit was allowable only if there was "no form" in which dividends could be paid.

Furthermore, in explaining one of the amendments of Section 26 made by Section 501 (a) of the Revenue Act of 1942, the Senate Committee on Finance explained in its report that the purpose was to afford relief to certain corporate taxpayers which did not have "sufficient assets" to make distributions permitting escape from the surtax on undistributed profits. S. Rep. 1631, 77th Cong., 2nd Sess., p. 245.

Fourth. The reason assigned by the Tax Court for denying a credit under Section 26 (c) (1) in this cause was (R. 23-24) that if a credit for dividends-paid is obtainable under Section 27 (e) of the Revenue Act of 1936 with respect to a taxable stock dividend, it is "apparent therefore" that no credit is allowable under Section 26 (c) (1). This reason would not of course support a denial of credit where, as here, the taxpayer had no unissued authorized stock, or where, as in the *Dakota* and *Kaufmann* cases, the taxpayer had only one authorized class of stock, and hence could not obtain a dividends-paid credit. However, that it is unsound in any event is demonstrated by the fact that, were it sound, it would apply with equal force where credit is claimed under subdivision (2). Yet its inapplicability where subdivision (2) is in issue is manifest, and it was so held in *G. B. R. Oil Corporation* v. *Commissioner*, 40 B. T. A. 738.

Fifth. The reason advanced in the *Kaufmann* case for adoption of the rule of the *Dakota* case is (p. 669) that

where the taxpayer has only one class of authorized stock or all authorized stock is issued, the prohibition is one imposed by the corporate charter and not by the contract and hence falls under the condemnation of *Helvering* v. *Northwest Steel Mills*, 311 U. S. 46.

This is specious reasoning. Where a contract prohibits the payment of all dividends except stock dividends, both the prohibition and the exception are contractual. One looks outside the contract only to find the limits or meaning of the exception, and where share-distributions are excepted from the operation of the contract, it is to be presumed that the parties intended to except only such share-distributions as the corporation is otherwise legally authorized to make. The permissive grant is to be read as extending only to what may be done lawfully, not as extending to what the law does not allow.

The court below in answer to this argument said (p. 484) that "the corporation was at liberty to amend its charter if necessary to authorize" more stock. This is plain error: a corporation may not amend its charter; only the shareholders may do that.[4]

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[4]The court prefaced the quoted words with the qualifying phrase "so far as this record goes". Both the Circuit Court below (**Merchants' Exch. Bank** v. **McGraw**, 59 Fed. 972, 977) and the Tax Court (**Tonawanda Power Co.** v. **Commissioner**, 3 B. T. A. 1195, 1199) have held that the doctrine of judicial notice supplies such evidence as may be necessary to establish what a corporation may or may not do under the laws of the state of its incorporation. Moreover, the controlling Washington statutes were set out in the respondent's brief before the Circuit Court below, and they showed that only the shareholders could amend the charter.

The Contract Did Not Permit the Payment of Dividends in the Taxpayer's Own Obligations.

As has already been pointed out, the Tax Court's decision was silent as to whether dividends in the taxpayer's own obligations were within the prohibition of the contract. We think it fair nevertheless to say that the Tax Court may be regarded as having concluded that such dividends were within the prohibition and that, had it deemed an express finding necessary, the finding would have been to that effect. We make this statement for two reasons. The first is that, with respect to the Commissioner's argument (R. 23) that "the contract did not bar the payment of dividends in forms other than cash", the Tax Court mentioned only stock dividends as being outside the prohibition. The second reason is that it had refused to accept similar arguments in previous cases; in the *Paraport* case, for example, it had made the following answer to such a contention (p. 111):

> This contention, so far as it relates to the payment of dividends in bonds, requires but little discussion. The payment of dividends in bonds * * * would have effectively dissipated the security provided for the benefit of the lessor and would have been a plain attempt at evasion of the prohibitory provision of the contract.

We think it clear as a matter of law that the bank-creditor could under the terms of the contract have enjoined distribution of the taxpayer's obligations to its shareholders. Any other view would manifestly permit the taxpayer to destroy the security the contract was intended to provide. It is no answer to say, as did the Circuit Court of Appeals (137 F. (2d) 481, 484), that the obligations could be "in the form of bonds or long-term obligations": in the first place, if the taxpaper had the right to distribute its own obligations, it had also the right to fix their terms; second, even if long-term obligations were distributed, bankruptcy might intervene be-

fore maturity and the shareholders would then as creditors be entitled to pro rata participation with the bank; third, the indebtedness to the bank was represented by a running account without fixed maturity, and even long-term obligations might mature while the bank was still unpaid.[5] This last consideration makes inapplicable the decision of the Circuit Court of Appeals for the Second Circuit in *Commissioner* v. *Oswego Falls Corporation* (C. C. A. 2d), 137 F. (2d) 173 (reversing on another ground the Tax Court's decision in *Oswego Falls Corporation* v. *Commissioner, supra*), inasmuch as there the debt had a fixed maturity and the court held that bonds could have been distributed calling for payment at a later date. However, the *Oswego* appellate decision is unsound in any event, for the first two reasons assigned above.[6]

Respectfully submitted,

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January, 1944

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[5]The Circuit Court of Appeals did not say what "long-term" obligations are. In the business world they are generally understood as obligations maturing after more than one year. See Paton, Accountants' Handbook, 3d ed., pp. 883-884.

[6]The Circuit Court of Appeals below tried to override the legal effect of the contract by saying (137 F. (2d) 481, 484) that the bank's officer testified that the bank "wanted to make sure that undue amounts of cash would not be disbursed", the court's intended implication being that the bank was not concerned about obligation-distributions. Of course the bank's rights under the contract could not be impaired by the officer's testimony as to what the bank's motive was. Furthermore, the court's statement is untrue; in the same breath the officer said (R. 48) that the bank was in like manner concerned that no notes be issued.

Had the contract been ambiguous, then its practical interpretation by the parties was important (**Topliff** v. **Topliff**, 122 U. S. 121, and **Brooklyn Life Ins. Co.** v. **Dutcher**, 95 U. S. 269) and the appellate court should have sent the case back to the trial tribunal for a finding based on the evidence as to interpretation.

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573816—44——1

In the Supreme Court of the United States

OCTOBER TERM, 1943

No. 644

VALENTINE-CLARK CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 15–25) is reported at 46 B. T. A. 821. The opinion of the Circuit Court of Appeals (R. 87–93) is reported at 137 F. 2d 481.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on August 3, 1943 (R. 93–94), and petition for rehearing was denied August 31, 1943 (R. 101). An extension of time to January 29, 1944, was secured for filing a petition for a writ of certiorari (R. 103), and a petition was

filed on January 28, 1944. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the petitioner was prohibited by its written contract from paying dividends in any form and is thereby entitled to credits in the taxable years under Section 26 (c) (1) of the Revenue Act of 1936.

STATUTES AND REGULATIONS INVOLVED

The applicable statutes and regulations are set forth in the Appendix, *infra*, pp. 14–20.

STATEMENT

The facts as found by the Board of Tax Appeals (R. 16–22) may be summarized as follows:

The petitioner, a Washington corporation having its principal office in St. Paul, Minnesota, is engaged in the business of treating cedar poles and other forest products. It keeps its books and files its income tax return on the accrual basis of accounting (R. 16).

During 1935 the petitioner's authorized capital stock consisted of 1,000 shares of common stock of a par value of $100, all of which was beneficially owned by Lillian S. Clark or her daughter, Grace C. Pyle (R. 16–17).

From 1933 until 1935, petitioner's business was operated under a line of credit established with

the Northwestern National Bank & Trust Company of Minneapolis, hereinafter referred to as the Northwestern Bank. Although its business had continued to improve, the petitioner in 1935 found itself without sufficient funds to purchase materials in such quantities as were necessary to handle its business. This condition was due to the fact that more capital was needed to take care of the expanding sales and the further fact that in each year all net earnings were being taken out of the business, one-half by M. H. Sperry, the general manager, as compensation under his contract of employment and one-half by Mrs. Clark and Mrs. Pyle in the form of dividends. In 1935 Clarence E. Hill, vice president of the Northwestern Bank, advised petitioner that so long as that state of affairs continued the bank would not allow any further extension of credit, and, furthermore, would insist that existing bank loans be paid, and that the only conditions under which the bank would make any further loans were that annual withdrawals for salaries to officers and for dividends to shareholders be limited to a total of $12,000, and, further, that Sperry or whoever was responsible for the active direction of the petitioner's affairs would be required to have a personal investment at stake in the enterprise (R. 17).

After holding several conferences with an attorney and with officers of the bank, Mrs. Clark and Sperry advised the bank that its terms for further extension of credit would be met (R. 17).

Pursuant thereto, on November 18, 1935, petitioner as first party, Lillian S. Clark as second party, and M. H. Sperry as third party executed a written agreement, the material portions of which are as follows (R. 18–19):

> 1. Second party agrees that so long as such line of credit is made available to first party by said bank and/or so long as any indebtedness of first party exists in favor of said bank on account of loans made under said line of credit, she will not make or permit withdrawals from the corporate funds to herself or any members of her family by way of salaries, dividends, loans or advances in excess of $6,000.00 per year (which last mentioned amount, however, may be paid to her and/or any member of her family as she may designate in monthly instalments). This agreement shall become effective as of January 1st, 1936, and between that date and the date of this memorandum any such withdrawals by second party and/or any member of her family shall not exceed the sum of $700.00 per month for the months of November and December, 1935.
>
> 2. Third party agrees that so long as such line of credit is made available to first party by said bank, and/or so long as any indebtedness of first party exists in favor of said bank on account of loans made under said line of credit, he will not make withdrawals or accept payment from said cor-

poration on account of compensation other than as follows:

(a) With regard to his salary now fixed at $7500.00 per year, he will not draw out in cash more than $6000.00 per year, which may be paid to him in monthly instalments. The balance of said fixed salary shall remain as an obligation of first party to him and shall be evidenced either as a credit to him on the corporate books or by a corporate note to be given to him.

(b) With regard to his right to additional compensation to the extent of one-half of the annual net earnings of first party, he shall not withdraw any such amounts to which he may be or become entitled but the same shall remain as a corporate obligation to him to be evidenced either by credits to him on the corporate books or by a corporate note or notes to be given to him.

This agreement shall become effective as of January 1st, 1936; and between that date and the date of this memorandum third party shall be entitled to withdraw the full unpaid instalments of his said fixed salary for 1935, but shall not withdraw any amounts to which he may be entitled as his share of the corporate earnings for 1935.

To conform further with the condition that Sperry acquire a personal investment in the enterprise, Sperry, Mrs. Clark, and Mrs. Pyle, on November 23, 1935, signed another contract which provided, among other things, that Mrs. Clark

and Mrs. Pyle would cause petitioner's capital structure to be revised on or before January 1, 1936, so as to authorize 1,500 shares of preferred stock of the par value of $100 each and so as to reduce and authorize common stock to 200 shares without par value; and that Sperry's 1933 contract of employment should be terminated and he would be given a new contract running seven years beginning January 1, 1936, and providing for a minimum annual salary of $6,000 (R. 20).

The changes thus provided for in petitioner's capital structure were completed not later than December 30, 1935, and the new stock was issued on that date. Of the 1,500 shares of preferred stock, 1,312½ shares were issued to Mrs. Clark and the remaining 187½ shares to Mrs. Pyle, and they were the owners thereof during the taxable years. Of the 200 shares of common stock, 85 shares were issued to Mrs. Clark, 15 to Mrs. Pyle, and 100 to Sperry, and the common stock was so held until August 20, 1936. From that date until June 30, 1937, the said 200 shares were held as follows: 20 shares by Mrs. Clark, 30 shares by Mrs. Pyle, 50 shares by Mrs. Clark and Mrs. Pyle as joint tenants, and 100 shares by Sperry (R. 21).

After petitioner delivered to the bank copies of the two contracts above described, the bank opened a line of credit for taxpayer. It did so in reliance upon the terms and conditions set

forth in those contracts. Between January 1, 1936, and June 30, 1937, the line of credit was continuously indebted to the bank. At no time during that period was petitioner able to make payment in full of its indebtedness to the bank without adversely affecting its business and competitive position (R. 21).

In November, 1936, petitioner requested the Northwestern Bank for permission to pay dividends and salaries in excess of the limits specified in the contract of November 18, 1935. Such permission was denied as to dividends, but the bank gave its approval to the payment of a $2,500 bonus to Sperry and such bonus was paid (R. 21).

In June, 1937, petitioner requested the bank, first orally and then by letter, for permission to pay dividends in excess of the limits prescribed in the contract of November 18, 1935. The bank, first orally and then by letter, gave petitioner permission to pay a dividend on its common stock of $5,000 in cash and $15,000 in petitioner's notes, on condition that such notes be subordinate to all bank loans and on the further condition that the notes mature not earlier than two years from date. A dividend was declared and paid as thus permitted (R. 22).

Petitioner's balance sheets dated December 31, 1936, and June 30, 1937, show earned surplus in the respective amounts of $25,905.33 and $28,966.36 (R. 22).

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Upon the basis of the foregoing facts the Board held that the contract of November 18, 1935, did not prohibit the payment of taxable stock dividends, and that, in computing the surtax on undistributed profits for 1936 and the period January 1 to June 30, 1937, the Commissioner correctly disallowed to the taxpayer a credit under the provisions of Section 26 (c) (1) of the Revenue Act of 1936 (R. 24–25). The Circuit Court of Appeals affirmed the Board's decision (R. 93–94) and denied the petition for rehearing (R. 101).

ARGUMENT

In computing the surtax imposed upon a corporation under the Revenue Act of 1936, a credit is allowed by Section 26 (c) (1) (Appendix, *infra*) to the extent of—

> An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends.

This case presents the question of whether the petitioner is entitled to such a credit by reason of its contract of November 18, 1935, in which its president and principal stockholder agreed that so long as a line of credit was made available to the petitioner by a certain bank, she would not make

or permit withdrawals from the corporate funds to herself or any members of her family by way "of salaries, dividends, loans or advances in excess of $6000.00 per year" (R. 18). The Board of Tax Appeals held that, since this contract did not prohibit the payment of stock dividends, the petitioner was not entitled to the credit (R. 24). The court below affirmed the Board's decision (R. 87–93).

The decision of the court below is in accord with *United States* v. *Dakota Tractor & Equipment Co.,* 125 F. 2d 20 (C. C. A. 8th), in which this Court denied a petition for a writ of certiorari, 316 U. S. 671; and *Commissioner* v. *Columbia River P. M.,* 127 F. 2d 558 (C. C. A. 9th). In those cases Section 26 (c) (1) was construed as covering dividends in any form whatsoever and not as applying merely to dividends payable in cash. See also *Commissioner* v. *Oswego Falls Corp.,* 137 F. 2d 173 (C. C. A. 2d). The administrative construction of the statute is to the same effect. Article 26–2 (b) of Regulations 94 (Appendix, *infra*).

Such construction of the statute is further supported by decisions holding that Section 26 (c) (1) grants a special credit in the nature of a deduction and must be strictly construed against the taxpayer who has the burden of showing that it comes within the exact statutory terms. *Helvering* v. *Ohio Leather Co.,* 317 U. S. 102; *Helvering* v. *Northwest Steel Mills,* 311 U. S. 46.

Notwithstanding these decisions, the petitioner argues that Section 26 (c) (1) should not be construed as applying to stock dividends or dividends of any kind but those payable in cash. The statute, however, is not so limited in terms and the petitioner cites no cases which support such a construction. Instead, it relies on a statement made on the Senate floor as to a change in the provision there. The statement, however, is quite inconclusive on the question,[1] and a construction of the word "dividends" to include stock dividends would seem to be in accord with the legislative purpose in enacting the undistributed profits tax law. See *Commissioner* v. *Columbia River P. M., supra,* p. 560. Section 27 of the same Act (Appendix, *infra*) is *in pari materia,* Section 27 being designed to grant credit for

[1] Section 15 (a) of H. R. 12395, as introduced in the Senate, provided: "If under a written contract executed by the corporation prior to March 3, 1936, there is no form in which dividends equal to the adjusted net income for the taxable year may be paid during the taxable year without violating a provision of such contract expressly dealing with the payment of dividends," the tax should be computed in a certain manner provided it did not increase the tax which would otherwise be payable. The statement of Senator La Follette that the Senate revision (which became Section 26 (c) (1) of the Revenue Act of 1936) was a more liberal provision may well be explained by the fact that the critical date for entering into contracts restricting dividends was extended to May 1, 1936. The significance of the earlier date was that it was the date on which the President sent a message proposing that a tax be levied on the undistributed profits of corporations. H. Rep. No. 2475, 74th Cong., 2d Sess., pp. 1–3.

dividends actually paid and Section 26 (c) (1) being designed to give a credit to corporations which could not pay dividends because of a contract. Inasmuch as Section 27 makes specific provision for dividends payable in cash, in kind, in obligations of the corporation and for taxable and nontaxable stock dividends, Congress must have intended that Section 26 (c) (1), as a complementary section, should have the same scope, particularly as there is no limiting phrase in that section.

While petitioner concedes that there is no conflict in the cases, it indicates that there has been considerable uncertainty in Board decisions on the issue here and that clarification is needed. Such an uncertainity would not constitute a basis for certiorari but in any event none of the cases to which the petitioner refers supports the interpretation of Section 26 (c) (1) which it contends for here. Instead, the Board decisions, as well as other cases in point, agree that the term "dividends" should be defined as including stock dividends.[2] Consequently, under any of the cases,

[2] The only difference of opinion has been over the question of whether stock dividends which are nontaxable in the hands of stockholders are covered by Section 26 (c) (1) under the term "dividends" as well as taxable stock dividends. In some earlier cases, the Board held that the credit should be denied only where taxable stock dividends could be paid. See *Helms Bakeries* v. *Commissioner*, 46 B. T. A. 308; *Paraport Theatre Leasing Corp.* v. *Commissioner*, 44 B. T. A. 108. While there have been some inconsistencies, more recently the Board has

the credit should be denied here inasmuch as the contract dealt only with cash dividends, and stock dividends could have been distributed without violating the provision of its written contract.

Furthermore, if facts outside the contract are to be considered, the evidence here is ample to support the Board's finding that there was no intention to restrict the payment of dividends in stock, taxable or otherwise (R. 24.) In fact, it was contemplated when the contract was made that new stock would be issued under a plan to give petitioner's manager a proprietary interest in the company, and such plan was carried out by issuing both common and preferred stock. During the taxable years, the petitioner had net income and earned surplus which could have been transferred to its capital account if stock dividends had been issued (R. 11, 12, 53, 55). Also under the law of Washington (Appendix, *infra*), petitioner could have easily changed its capital structure again, if necessary, in order to declare stock dividends. And, having two classes of stock during the taxable years, it could have

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been construing Section 26 (c) (1) more strictly. Thus while it looked at first beyond the contract to determine whether the taxpayer could pay a taxable stock dividend, it now holds that the right to the credit depends entirely on the contract and if there is nothing therein to prohibit a stock dividend, it has denied the credit without consideration of other facts. *Oregon Pulp & Paper Co.* v. *Commissioner*, 47 B. T. A. 772. *Kaufmann Department Stores Securities Corp.* v. *Commissioner*, 2 T. C. 656.

issued stock dividends which would have been taxable in the hands of its stockholders, if taxability of a dividend is a prerequisite to prevent the granting of a credit under Section 26 (c) (1), but see *United States* v. *Dakota Tractor & Equipment Co., supra,* indicating otherwise. However, we submit that the provisions of the contract should be decisive of the issue and the contract here did not refer to or prohibit the distribution of stock dividends.

CONCLUSION

The decision of the court below is correct, and the petition for a writ of certiorari should be denied.

Respectfully submitted.

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FEBRUARY 1944.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) *Definitions.*—As used in this title—

(1) The term "adjusted net income" means the net income minus the sum of—

(A) the normal tax imposed by section 13.

(B) The credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

* * * * *

(2) [as amended by Sec. 501 (a) (1) of the Revenue Act of 1942, c. 619, 56 Stat. 798] The term "undistributed net income" means the adjusted net income minus the sum of (A) the dividend paid credit provided in section 27, (B) the credit provided in section 26 (c) relating to restrictions on payment of dividends, (C) except in cases where section 26 (c) (1) is applicable, the deficit credit provided in section 26 (f), and (D) the redemption credit provided in section 26 (g).

* * * * *

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

(c) *Contracts Restricting Payment of Dividends.*—

(1) *Prohibition on Payment of Dividends.*—An amount equal to the excess of

the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

* * * * *

SEC. 27. CORPORATION CREDIT FOR DIVIDENDS PAID.

(a) *Dividends Paid Credit in General.*—For the purposes of this title, the dividends paid credit shall be the amount of dividends paid during the taxable year.

* * * * *

(e) *Taxable Stock Dividends.*—In case of a stock dividend or stock right which is a taxable dividend in the hands of shareholders under section 115 (f), the dividends paid credit with respect thereto shall be the fair market value of the stock or the stock right at the time of the payment.

* * * * *

(h) *Nontaxable Distributions.*—If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title for the period in which the distribution is made, no dividends paid credit shall be allowed with respect to such part.

Remington's Revised Statutes of Washington, 1940 Annual Pocket Part for Volume 5:

§ 3803–24. *Capital carried as liability—Computation—Dividends how Paid.*

* * * * *

4. No corporation shall pay dividends,

a. in cash or property, except from the surplus of the aggregate of its assets over the aggregate of its liabilities, including in the latter the amount of its capital stock, after deducting from such aggregate of its assets the amount by which such aggregate was increased by unrealized appreciation in value or revaluation of fixed assets;

b. in shares of the corporation, except from the surplus of the aggregate of its assets over the aggregate of its liabilities, including in the latter the amount of its capital stock.

* * * * *

6. Subject to the limitations contained in this section, a dividend may be declared in shares of the corporation whenever the board of directors so determine: *Provided,* That

a. if the dividend is to be paid in shares having a par value, the aggregate par value of such shares shall not exceed the amount of that portion of the corporation's surplus which is transferred to capital as payment for such shares;

b. if the dividend is paid in shares having no par value, the number of such shares may be fixed by the board of directors;

c. no dividend payable in shares of any class shall be paid to shareholders of any other class unless the articles so provide or such payment is authorized by the vote of the holders of a majority of the shares of

the class in which the payment is to be made [L. '33, p. 785, § 24].

* * * * *

§ 3803–37. *Amendment of articles.*

1. A corporation may, at a meeting of the shareholders duly called upon notice of the specific purpose, and in the manner herein provided, amend its articles in any respect so as to include any provision authorized by this act, or so as to extend the period of its duration for a further definite time or perpetually.

* * * * *

3. An amendment altering the articles of incorporation in any other respect may be adopted by vote of the holders of two-thirds of the voting power of all shareholders, or by such vote as the articles of incorporation require.

* * * * *

5. Any amendment which might be adopted at a meeting of [a] shareholders as provided in this section, may be adopted without such a meeting being held if written consent to the amendment has been given by all shareholders entitled to vote thereon as provided in this section [L. '33, p. 798, § 37].

§ 3803–38. *Amendatory articles—Certificate.*

I. After an amendment has been adopted, articles of amendment shall be prepared in triplicate originals, setting forth the amendment and the adoption thereof, and shall be signed and sworn to by the president or vice-president and the treasurer or secretary or assistant secretary.

II. The triplicate originals of the articles of amendment shall be delivered to the Secretary of State. If the Secretary of

State finds that the articles of amendment conform to law, he shall put an endorsement of his approval upon each set, and when all taxes, fees and charges therefor have been paid as required by law, he shall file one of such sets in his office and record the same and shall issue a certificate of amendment. Thereupon the amendment shall become effective.

III. The certificate of amendment together with the two remaining sets of the articles of amendment bearing the endorsement of the fact and time of filing in the office of the Secretary of State shall be returned to the corporation. One of the sets of the articles of amendment shall then be filed in the office of the Auditor of the county in which the registered office of the corporation is located, and the other shall be retained by the corporation [L. '39, ch. 143, § 6, p. 430, amending L. '33, ch. 185, § 38].

§ 3803–39. *Increase or decrease of shares.*

1. If the total number of shares is to be increased or decreased the articles of amendment shall also state:

a. the total number of shares, including those previously authorized, which the corporation will thenceforth be authorized to have;

b. the number of shares that have a par value and the par value thereof, and the number of shares that have no par value, and

c. if shares are divided into more than one class, a description of the classes and a statement of the number of shares in each class and of the relative rights, voting power, preferences and restrictions granted to or imposed upon the shares of each class.

2. If shares having a par value are to be changed into an equal or different number of shares having no par value, the amount of the consideration for which shares having no par value are allotted to take the place of outstanding shares having a par value shall be deemed to be the amount of the aggregate par value of such outstanding shares, or, if the actual value of such shares be less than their par value, the consideration may be stated in the articles of amendment to be their actual value.

3. If shares having no par value are to be changed into an equal or different number of shares having a par value, the shares having a par value which are allotted to take the place of outstanding shares having no par value shall be taken to be fully paid for, but the aggregate par value of such shares shall not exceed the actual value of the assets of the corporation, less its liabilities, represented by the shares having no par value so exchanged.

4. If shares having no par value are to be changed into a different number of the same class or of any other class or classes of shares having no par value, the corporation shall be deemed to have received for such new shares as represent or take the place of such outstanding shares the amount of the capital of the corporation represented by the outstanding shares so changed [L. '33, p. 800, § 39].

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 26–2. *Credit in connection with contracts restricting payment of dividends.*—

* * * * *

(b) *Prohibition on payment of dividends.*—The credit provided in section 26 (c) (1) is allowable only with respect to a written contract executed by the corporation prior to May 1, 1936, which expressly deals with the payment of dividends and operates as a legal restriction upon the corporation as to the amounts which it can distribute within the taxable year as dividends. If an amount can be distributed within the taxable year as a dividend—

(1) in one form (as, for example, in stock or bonds of the corporation) without violating the provisions of a contract, but can not be distributed within the taxable year as a dividend in another form (as, for example, in cash) without violating such provisions, or

(2) at one time (as, for example, during the last half of the taxable year) without violating the provisions of a contract, but can not be distributed as a dividend at another time within the taxable year (as, for example, during the first half of the taxable year) without violating such provision—

then the amount is one which, under section 26 (c) (1), can be distributed within the taxable year as a dividend without violating such provisions.

U. S. GOVERNMENT PRINTING OFFICE: 1944